(17)

No. 96-1578

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1997

THOMAS R. PHILLIPS, RAUL R. GONZALEZ, NATHAN L. HECHT, JOHN CORNYN, CRAIG T. ENOCH, ROSE SPECTOR, PRISCILLA R. OWEN, JAMES A. BAKER, and GREG ABBOTT, in their official capacities as Justices of the Supreme Court of Texas; TEXAS EQUAL ACCESS TO JUSTICE FOUNDATION; and W. FRANK NEWTON, in his official capacity as Chairman of Texas Equal Access to Justice Foundation,

Petitioners,

v.

WASHINGTON LEGAL FOUNDATION, WILLIAM R. SUMMERS, and MICHAEL J. MAZZONE,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS

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59 pp

QUESTION PRESENTED

Pursuant to the Court's June 27, 1997 order, the question presented by this case is as follows:

> Is interest earned on client trust funds held by lawyers in IOLTA accounts a property interest of the client or lawyer, cognizable under the Fifth Amendment of the United States Constitution, despite the fundamental precept of IOLTA that such funds, absent the IOLTA program, could not earn interest for the client or lawyer?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page

Cases:

Constitution, Statutes, and Regulations:

Miscellaneous:

BRIEF FOR RESPONDENTS

STATEMENT OF THE CASE

This case arises from a suit brought by Respondents in federal district court in Texas. The suit alleges that the Texas IOLTA ("Interest on Lawyers' Trust Accounts") program violates Respondents' rights under the First and Fifth Amendments to the United States Constitution. Petitioners ask the Court to reverse a ruling of the United States Court of Appeals for the Fifth Circuit that interest earned on IOLTA accounts is the "private property" -- within the meaning of the Fifth Amendment's Takings Clause -- of those whose funds are deposited into IOLTA accounts. Petition Appendix ("Pet. App.") 1a-19a.

Attorney Trust Accounts

It is (and has been for centuries) a common practice for attorneys to hold funds belonging to their clients in connection with their practice of law. The experience of Respondent Michael Mazzone is typical of lawyers throughout the nation. Mr. Mazzone "ha[s] determined from experience that as a practical matter [he] cannot operate [his] law practice without collecting client funds" and holding them in trust for his clients. Joint Appendix ("J.A.") 83.

Prior to 1980, a lawyer generally held client trust funds in a non-interest bearing, federally-insured checking account in which all of his/her clients' trust funds were pooled. Pooled accounts provided for administrative convenience and ready access to funds. Such accounts were non-interest bearing because federal law had (since the Depression) prohibited federally-insured banks and savings and loans

from paying interest on *checking* accounts. *See* 12 U.S.C. §§ 371a, 1464(b)(1)(B), 1828(g). When a client placed a large amount of funds in trust with his attorney, however, such funds were generally placed into interest-bearing *savings* accounts, because the interest generated outweighed the inconvenience caused by the absence of check-writing capability.

Starting in 1980, the combination of gradual relaxation of federal restrictions on interest payments by financial institutions and the improved technology available to those institutions greatly expanded the opportunities available for earning interest on deposited funds. The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (amending various sections of Title 12 U.S.C.) expanded the interest-generating capacity of bank deposits in several crucial ways. In particular, it authorized creation of interest-bearing Negotiable Order of Withdrawal (NOW) accounts, which operate like traditional checking accounts. 12 U.S.C. § 1832. It also withdrew, over a six-year period, most controls over the maximum rate of interest that financial institutions were permitted to pay on savings accounts. 12 U.S.C. §§ 3501-3509.

These and other regulatory changes, coupled with advances in technology, have produced a range of options through which customers are able to earn a market rate of interest on their funds while at the same time enjoying the convenience of check writing. These options include the ability to transfer funds freely among different types of accounts; and to pool the deposits of several individuals in a single account, with the bank computing interest and principal separately for each depositor (a banking service

generally referred to as "sub-accounting"). *See, e.g.*, Affidavit of Robert J. Randell, J.A. 95-105.

Creation of IOLTA Programs

A number of states, beginning with Florida in 1981, moved quickly to establish IOLTA programs in order to take advantage of the income-producing potential created by the decontrol legislation. Under such programs, interest earned on pooled attorney trust accounts is paid to foundations established by state supreme courts, and those foundations in turn distribute funds to groups that hire attorneys who purport to represent the interests of low-income individuals.

The IOLTA program in Texas was created by order of the Supreme Court of Texas effective May 9, 1984. The order, now codified as Article XI of the State Bar Rules, provided that an attorney receiving client funds that were "nominal in amount" or were "reasonably anticipated to be held for a short period of time" was permitted to place the funds into an unsegregated interest-bearing bank account (an "IOLTA account") and to pay interest earned on those funds to a nonprofit corporation to be established by rules to be promulgated by the Supreme Court of Texas. TEX. STATE BAR R. art. XI, § 5, *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. (Vernon 1984).

To implement Article XI, the Supreme Court of Texas by order dated April 30, 1984 adopted its "Rules Governing the Operation of the Texas Equal Access to Justice Program" (the "IOLTA Rules"). J.A. 108-125. The IOLTA Rules established Petitioner Texas Equal Access to Justice Foundation ("TEAJF") as the nonprofit corporation that was to receive funds paid into the IOLTA program. Consistent

with Article XI, the IOLTA Rules specified that funds forwarded to TEAJF from IOLTA accounts were to be awarded as grants solely to nonprofit organizations that "have as a primary purpose the delivery of legal services to low income persons." J.A. 116.

During the first four years of operation of the IOLTA program (1985-88), funds forwarded from IOLTA accounts to TEAJF never exceeded $1 million per year. On December 13, 1988, the Supreme Court of Texas amended Article XI and the IOLTA Rules to make participation in the Texas IOLTA program mandatory. Pursuant to the amended Article XI and the amended IOLTA Rules, attorneys in Texas who "hold client funds that are nominal in amount or are reasonably anticipated to be held for a short period of time" *must* place the funds in an unsegregated "interest-bearing insured depository account," with interest earned thereon to be paid to TEAJF. Rule 4, J.A. 111.

The issue of whether client trust funds "are nominal in amount or held for a short period of time," and thus required to be placed in IOLTA accounts, is addressed by Rule 6 of the IOLTA Rules. Rule 6 requires funds to be placed in IOLTA accounts:

> [I]f such funds, *considered without regard to funds of other clients which may be held by the attorney*, law firm or professional corporation, could not reasonably be expected to earn interest for the client or if the interest which might be earned on such funds is not likely to be sufficient to offset the cost of establishing and maintaining the account, service charges, accounting costs and tax reporting costs which would be incurred in attempting to obtain interest on such funds for the client. Also to be considered are the nature of the proceeding or transaction involved and the likelihood of delay in the need for such funds in such proceeding or transaction. (Emphasis added.)[1]

The IOLTA Rules provide for severe enforcement measures against any attorney who fails to comply with IOLTA program requirements. For example, Rule 24 provides for the automatic suspension of the law license of any attorney who fails to submit an annual "compliance statement" certifying that he is maintaining an IOLTA account in accordance with the IOLTA Rules. J.A. 122-123. On the other hand, Article XI, § 7 and Rule 23 both provide immunity to attorneys who act "in good faith" in determining whether to place client trust funds in IOLTA accounts.

The switch from a voluntary to a mandatory IOLTA program became effective as of July 1, 1989. As a result of that switch, interest income generated by the Texas IOLTA program has increased several-fold -- to nearly $10 million dollars in its highest year (1991). Nationwide, IOLTA pro-

[1] As is discussed in more detail below (*supra* at 39 n.15), TEAJF's interpretation of the highlighted language has changed during the course of this litigation. TEAJF officials for many years interpreted that language as requiring the maintenance of a separate account for each client whose funds the attorney desired to keep outside the IOLTA program. That separate-account requirement precluded placement of client trust funds into pooled non-IOLTA, interest-bearing accounts, with the bank providing sub-accounting services that keep track of each client's share of the account. (Such sub-accounting can significantly reduce the per-client administrative cost of maintaining trust accounts. J.A. 97-100.) In the court of appeals, Petitioners adopted a new interpretation of Rule 6; they now interpret Rule 6 as permitting sub-accounting in connection with non-IOLTA trust accounts, provided that use of such accounts is otherwise permissible under the Rule. Fifth Circuit Brief of TEAJF and Newton at 7-8.

grams generate in excess of $100 million per year (Pet. Br. at 3), indicating that on a typical day in excess of $5 billion in client funds is being held in IOLTA accounts.

Respondents' Relationship with the IOLTA Program

Respondents in this action are an attorney licensed to practice law in the State of Texas; a citizen of Texas who currently has funds being held in an IOLTA account; and a public interest law firm, the Washington Legal Foundation.

The Texas lawyer is Respondent Michael J. Mazzone. In accordance with Article XI and the Rules, Mr. Mazzone maintains an IOLTA account into which he regularly deposits client funds that are (as defined by Rule 6) either nominal in amount or are reasonably anticipated to be held for a short period of time. J.A. 83.

The Texas citizen with funds currently being held in a Texas IOLTA account is Respondent William J. Summers. Mr. Summers is a businessman whose work requires him to make regular use of the services of attorneys. J.A. 85. In December 1992, Mr. Summers was named as a defendant in civil litigation. J.A. 86. Pursuant to the agreement under which he hired an attorney to represent him, Mr. Summers paid the attorney a small retainer. *Id.* The litigation is on-going, and the attorney continues to hold the retainer. *Id.* In January 1994, Mr. Summers learned for the first time that his attorney had deposited the retainer into his law firm's IOLTA account and that all interest earned on that account is paid to TEAJF to support Texas's IOLTA program. *Id.*

Proceedings Below

Respondents filed this action on February 7, 1994 in U.S. District Court for the Western District of Texas, alleging that the IOLTA program violated their rights under the First Amendment (by compelling them to financially support speech with which they disagree) and the Fifth Amendment (by taking their property without compensation). Named as defendants were TEAJF; W. Frank Newton, in his official capacity as Chairman of TEAJF; and the nine Justices of the Supreme Court of Texas (the "Justices"), in their official capacities as members of that court.

In a Memorandum Order and Judgment dated January 19, 1995, the district court granted Petitioners' motions for summary judgment and denied Respondents' motion for summary judgment. Pet. App. 20a-40a. The court found that the only funds eligible for deposit in an IOLTA account are those *incapable* of earning "net interest" (that is, interest after deduction of costs associated with maintaining an interest-bearing account) "if deposited by themselves in an individual (non-pooled) account" (*id.* at 29a) or if deposited in a pooled account offering sub-accounting. *Id.* at 24a n.2. The court reasoned that Respondents could have no "reasonable expectation" of earning interest on such funds and thus have no "property interest in interest proceeds that, but for the IOLTA Program, would never have been generated." *Id.* at 30a. Without such a property interest, the court concluded, Respondents could not state a Fifth Amendment taking claim based on TEAJF's appropriation of the interest proceeds. *Id.*

The district court rejected Respondents' First Amendment compelled speech claim on similar grounds. *Id.* at 34a-37a. Such a claim, the court stated, "is necessarily predicated upon" the assertion that "the funds generated from the IOLTA accounts are, in fact, the property of the client." *Id.* at 35a. Because the court had held that the interest generated by the IOLTA program was not the property of any of the clients, Respondents could have no First Amendment claim that they were forced to support speech they found objectionable. *Id.* The court likewise held that forcing attorneys to participate in the IOLTA program does not violate their First Amendment rights. *Id.* at 36a-37a.[2]

The court of appeals reversed the grant of summary judgment for Petitioners and remanded the case to the district court for further proceedings. *Id.* at 1a-19a. Labeling the IOLTA program a "modern-day attempt at alchemy" that seeks to create property from nothing (*id.* at 7a), the appeals court concluded that "it seems obvious that the interest earned in the IOLTA accounts is the property of the clients whose money is held in those accounts." *Id.* at 8a. Citing *Sellers v. Harris County*, 483 S.W.2d 242, 243 (Tex. 1972), the court stated, "Texas observes the traditional rule that 'interest follows principal,' which recognizes that interest earned on a deposit of principal belongs to the

[2] The court also rejected Respondents' alternative Fifth Amendment argument that TEAJF -- by using Respondents' funds without permission for purposes of generating IOLTA funds -- was violating their right to exclude others from the beneficial use of their funds. *Id.* at 32a-33a. While noting that this Court on numerous occasions has recognized the principle that the right to exclude others from one's property is an important strand in the bundle of rights that constitute "property," the district court held that the right to exclude others is fully applicable to "real or tangible property" only, not to "intangible property" such as money. *Id.*

owner of the principal." Pet. App. 8a. The court also relied on *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980), which it said mandated a finding that -- for purpose of Takings Clause analysis -- interest earned on IOLTA accounts must be deemed the property of those whose principal generated the interest. Pet. App. 12a.

The appeals court rejected Petitioners' argument that clients lack cognizable property rights in IOLTA interest because of their alleged inability to derive benefit from funds held in non-IOLTA trust accounts; the court said that *Webb's* "creates a rule that is independent of the amount or value of interest at issue." Pet. App. 12a. The court also said that the inability of some bank deposits to generate "net interest" was largely a result of features of the tax law, such as the requirement that all recipients of interest income be sent IRS Form 1099. *Id.* at 16a-17a n.47. The court said that the existence of a Fifth Amendment property right in interest income should not "hinge . . . on the fickle tax code," particularly since costs associated with operating small bank accounts are subject to rapid change. *Id.*

The appeals court remanded the case to the district court "for reconsideration in the light of the principles explained in this decision and for further factual development of the record." *Id.* at 17a.[3]

[3] The appeals court did not reach the ultimate issue of whether Petitioners' appropriation of interest generated by IOLTA accounts violated the Takings Clause. The appeals court's order vacating the grant of summary judgment for Petitioners revived Respondents' First Amendment claims as well, but the court's decision contains virtually no mention of those claims. Nor did the court address Respondents' alternative Fifth Amendment argument: that TEAJF was violating their right to exclude others from the

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On June 27, 1997, this Court granted review with respect to the first of two questions presented in Petitioners' certiorari petition. The Court agreed to consider whether interest earned on client trust funds held by lawyers in IOLTA accounts is a property interest of the client or lawyer, cognizable under the Fifth Amendment.[4] The Court declined to review the second question presented in the petition: whether the court of appeals had improperly applied principles of federal general common law.

SUMMARY OF ARGUMENT

Petitioners may not escape Fifth Amendment scrutiny of the Texas IOLTA program on the ground that Respondents lack property rights in interest paid on their money. As this Court has repeatedly recognized, the earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property. The "interest follows principal" rule flows naturally from the understanding of the nature of interest that has prevailed in Western society since the Reformation. Further, the rule that "interest follows principal" has been recognized in the common law for centuries and in the courts of all states that have addressed the issue, including the State of Texas. The

[3](...continued)
beneficial use of their funds.

The appeals court also affirmed that portion of the district court's order that held that TEAJF is an arm of the State of Texas and thus is entitled to Eleventh Amendment immunity with respect to Respondents' claims for monetary damages. *Id.* at 17a-19a.

[4] The Court revised Petitioners' rendition of the question presented to delete any reference to Respondents' First Amendment claims. J.A. 107.

rule is fully applicable regardless whether the owner of the property had a right to insist that interest be generated by his funds, regardless of the amount of interest at issue, and regardless whether the owner had a "reasonable, investment-backed" expectation of receiving interest.

The State of Texas may not evade Takings Clause review of its conduct by declaring that Texas law no longer recognizes property rights in income derived from small attorney trust accounts. It is true that property rights are, to a large extent, creatures of state law; but the Constitution imposes strict limits on the power of states to redefine traditional property rights. The Takings Clause was intended to prevent states from arbitrarily transforming private property into public property, even when it does so for a limited time only and regardless whether the property is already subject to extensive government regulation.

The Fifth Circuit's reversal of the grant of summary judgment was proper for the additional reason that virtually all clients would benefit financially if their funds were excluded from the IOLTA program. The factual premise underlying Petitioners' Question Presented -- that it is a "fundamental precept" of IOLTA that the only funds in the IOLTA program are those that could not earn interest for the client -- is demonstrably false. *Any* amount of money is capable of generating bank interest in a pooled account. It is true that in *some* instances the interest earned will be less than the lawyer's costs of administering that money. But the administrative costs of maintaining a non-IOLTA account are no higher than the administrative costs of maintaining an IOLTA account. The net result of the requirement that such funds must (in most instances) be placed in an IOLTA account is that interest generated by the client's funds is paid

to TEAJF rather than being used to defray the costs of maintaining the trust account.

Petitioners' argument that IOLTA interest is not the "private property" of clients -- within the meaning of the Takings Clause -- hinges entirely on their claim that accounting costs make it impracticable for interest to be generated on nominal and/or short-term funds. To the extent such a claim may once have been plausible, it clearly is no longer plausible in view of the explosion in new computer technology over the past two decades.

ARGUMENT

The issue before the Court is whether a client whose money is placed in an IOLTA account by his lawyer has a property interest in the income it generates while in that account. This question should be answered in the affirmative for a simple reason that has been explicitly recognized by this Court, and by many others: Interest is an inseparable incident of the principal for whose use it is paid. Just as the client has a property interest that would support suit against any governmental effort to deny the return of his principal, so he has a claim to the interest paid for the use of that principal. Governmental actions appropriating various types of interest in property may or may not be valid, depending on the authority and circumstances under which the government acts. But there can be no doubt that the owner of a fund has a property right in the income generated by the fund; government efforts to appropriate that income are thus subject to review under the Takings Clause.

Petitioners are understandably reluctant to focus directly on the narrow question before the Court. Thus, they flatly misstate the question presented as reaching the ultimate merits issue whether the IOLTA program results in a compensable taking.[5] Notwithstanding the clarity of this Court's grant of certiorari, Petitioners' supporting *amici* likewise devote their greatest attention to this issue.[6] Of course, the ultimate question of whether there has been a taking has not been decided by the courts below; that issue was to have been the subject of proceedings in the district court upon remand from the Fifth Circuit. Pet. App. 17a.

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[5] In their Statement of the Case, Petitioners falsely assert that "certiorari was granted to review the question whether IOLTA programs interfered with property rights in ways that violated either the First or the Fifth Amendments." Pet. Br. at 13. Likewise, in their Summary of Argument and Argument, they argue repeatedly that "[t]he Texas IOLTA program does not take 'property' from anyone." *Id.* at 13, 14, 18. So central is this point to their brief that the claimed failure of the IOLTA Program to effect a taking is made the focus of their two principal argument headings. *Id.* at 15, 17. In addition, they include seven pages in their brief addressed to the issue whether denial of the right to exclude others from the use of their property constitutes a taking --an issue plainly not included within this Court's grant of certiorari. *Id.* at 29-35.

[6] For example, *amici* argue that clients surrender control over the use of their principal when they deposit it into any bank account, and thus cannot complain about the character of the uses to which their principal is put, ABA Br. at 13, Br. of Massachusetts Bar Foundation at 11; that the "character of the governmental action" at issue here was merely regulatory and not a physical invasion, Br. of the American Association of Retired Persons ("AARP") at 13; Br. of the Columbus Bar Association ("Columbus") at 13-15; and that Respondents have suffered no adverse impact on reasonable investment-backed expectations, since historically, prior to IOLTA, nominal and short-term client deposits were deposited into non-interest-bearing accounts, U.S. Brief at 12-15, AARP Br. at 12, Columbus Br. at 13-15.

As to the question actually presented respecting a client's property rights in the interest a bank pays for the use of his principal, Petitioners and their *amici* offer little but a *reductio ad absurdum* of "the new property." *See* Charles Reich, *The New Property* 73 YALE L.J. 733 (1964). They begin with the well-established premise that state law may create expectations of government-conferred benefits amounting to constitutionally protected property rights. *See* Pet. Br. at 20; U.S. Br. at 9-10 (citing *Board of Regents v. Roth*, 408 U.S. 564, 577 (1972)). Working backward from that proposition, they appear to suggest that even the most fundamental forms of property rights -- like interest income, and presumably even the principal that produces it -- may be undermined and ultimately destroyed by a maze of regulation that sows confusion and undermines the expectations that a party would otherwise reasonably possess.[7] By

[7] The reasoning of *Roth* does not justify such a conclusion. *Roth*, of course, involved the question of when governmental actions should be viewed as affirmatively creating property. *Roth*, 408 U.S. at 576-77. *Roth* requires a legitimate claim of entitlement before a property interest in a government benefit can be recognized. *Id.* at 577. In such cases, the Court must examine closely state and federal rules and regulations to determine whether a protectible property interest exists. *See, e.g., Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 428-431 (1982)(property interest in claim brought under Illinois Fair Employment Practices Act); *Memphis Light, Gas and Water Div. v. Craft*, 436 U.S. 1, 9-12 (1978)(property interest in continued electric service); *Mathews v. Eldridge*, 424 U.S. 319, 332 (1976)(property interest in continued receipt of social security disability benefits).

In a variety of contexts, however, including Takings Clause and due process cases, the Court generally has found it unnecessary to engage in a detailed *Roth*-style analysis of whether traditional forms of property qualify as constitutionally protected property interests. *See, e.g., Babbitt v. Youpee*, 117 S. Ct. 727 (1997)(owner's right to direct descent of real property);

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that sleight of hand, Petitioners would allow government to accomplish the regulatory deconstruction -- and subsequent appropriation -- of every kind of traditional property right in a manner that forecloses review by a court.

Specifically, Petitioners rely on IOLTA's "precept" that funds should only be deposited which, when considered alone, "could not reasonably be expected to earn interest for the client." IOLTA Rule 6, J.A. at 113-14; *see* Pet. Br. at 6-7. Ignoring the vague and confusing nature of the pertinent regulations, Petitioners thus argue that the client, by definition, can have no expectation of benefit from the interest on his principal, and can therefore claim no property right in that interest. Indeed, Petitioners claim that the IOLTA program "generate[s] interest on otherwise unproductive funds . . .," Pet. Br. at 6, and the Solicitor General is so bold as to assert that the interest earned on IOLTA accounts is "a government-created value." U.S. Br. at 20. It is inconsequential to Petitioners and their *amici* that the interest is the direct product of the client's principal.

Petitioners thus state what they perceive to be the relevant legal inquiry: "When a client surrenders funds to an attorney, while retaining beneficial interest in the

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Concrete Pipe & Prod. of California, Inc. v. Constr. Laborers Pension Trust for S. California, 508 U.S. 602 (1993) ($268,168.81 penalty for pension plan withdrawal); *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 36 (1990)(money paid for tax); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1001-1004 (1984)(trade secret).

As in *Webb's*, this case does not concern government-conferred benefits, but rather an effort by the government to appropriate a traditional form of property.

principal, what expectation does that client have to interest income?" Pet. Br. at 20. The issue before the court, however, addresses not the right to "income potential" or *anticipated* earnings, but to *actual* earnings -- to the bank's actual payment for the use of clients' deposits that the Texas IOLTA program appropriates to the State of Texas. The relevant expectation to be examined is that of a depositor whose principal has, in fact, earned interest. The economic history of interest and interest rates, this Court's jurisprudence, and the common law of many states all show that when, as here, interest is paid for the use of the principal, the owner of the principal has a long-recognized and legitimate expectation that the interest belongs to him.

I. THE OWNER OF CAPITAL HAS A LEGITIMATE EXPECTATION OF RECEIVING ANY VALUE THAT MAY BE PAID BY OTHERS FOR THE USE OF THAT CAPITAL

A. Present Practice and History Make Clear That Interest Is Compensation Paid to the Owner of Money for Allowing Its Use by Another

In today's world, the use of credit is commonplace, and we take it as a given that interest is compensation a borrower pays to a lender for the use of the lender's money for an interval of time. Nor is this understanding especially recent. As the economist Eugene von Böhm-Bawerk observed in 1884:

> [W]hoever is the owner of a capital sum is ordinarily able to derive from it a permanent net income which goes under the scientific name of interest in the broad sense of the term.

> * * * *
>
> It arises independently of any personal act of the capitalist. It accrues to him even though he has not moved a finger in creating it, and therefore seems in a peculiar sense to arise from capital or, to use a very old metaphor, to be begotten by it.

Eugene von Böhm-Bawerk, *Capital and Interest* 1 (George D. Huncke & Hans Sennholz trans., 1959). That fact in itself gives rise to the expectation of any lender that, absent some other disposition that he may make, the interest a borrower pays for the use of his principal belongs to him as an incident of the principal itself. But the historical roots of that expectation also merit discussion here: they embody a centuries-long debate in which the propriety of paying the lender for the use of his money overcame religious and philosophical objections to achieve universal acceptance in recent centuries.

The extension of credit in exchange for the payment of interest is not a modern invention. "Loans at interest may be said to have begun when the Neolithic farmer made a loan of seed to a cousin and expected more back at harvest time." Sidney Homer and Richard Sylla, *A History of Interest Rates* 3 (3d ed. 1991). These earliest loans were made for productive purposes. Loans of seed yielded an increase of seeds, a portion of which could be returned with the principal. Loans of animals often yielded offspring, all or some of which could be returned with the animal. Similarly, loans of land could bear an obvious source of interest -- the first fruits of the land. *Id.* at 18-19. As recorded history progressed, there developed an increasing reliance upon credit as a means of paying for capital goods

that could themselves be used to produce income. And some form of payment to the lender as an inducement was often a central element of the transaction. *Id.* at 20-48.

Charging interest on loans has been regulated since ancient times; the practice was long criticized and sometimes banned by both secular and religious authorities. The ancient Israelites forbade charging interest, and the Romans prohibited interest in transactions between Romans. It was likewise opposed by the early Christian Church. Irving Fisher, *The Rate of Interest* 4 (Richard P. Brief ed., 1982); Homer and Sylla, *supra,* at 70.

The early opposition to usury centered on the notion of the sterility of money, which traces back to Aristotle. He observed that the Greek word for usury was also the word for offspring and argued against the nature of interest on the ground that money could not have offspring. Fisher, *supra*, at 4; Homer and Sylla, *supra* at 71. Money was intended only to be used as a medium of exchange, according to Aristotle, and charging interest was unnatural. Böhm-Bawerk, *supra*, at 10.

In the thirteenth century, the Scholastics articulated a view of usury that built on Aristotle's perceptions. In view of the supposed unproductiveness of money, their opposition was tied closely to the very definition that these writers gave to usury: "where more is asked than is given." Homer and Sylla *supra,* at 70; *see also,*Böhm-Bawerk, *supra,* at 14. Notwithstanding these condemnations -- which held substantial sway in secular legislation, Böhm-Bawerk, *supra,* at 16 -- the extension of credit in return for compensation persisted during the Middle Ages. Fisher, *supra*, at 5; Böhm-Bawerk, *supra*, at 11. There were in the late Middle Ages

numerous recognized exceptions to the ban on demanding compensation for lending money. Pawnshops, banks, and some money-lenders were expressly licensed. *Id.* at 17; Fisher, *supra*, at 5. Other practices, such as buying annuities (or "census" interests) in the fruits of land, and taking (and using) land in mortgage for money loaned, required implicit toleration of interest. Böhm-Bawerk, *supra*, at 17; Homer and Sylla, *supra*, 75.

Perhaps of greatest significance in contributing to the widespread acceptance of charging for the use of money was the recognition of a concept of "interest" as distinct from usury. While usury was understood as the payment back to the lender of more than was given, the distinct concept of *interesse,* which anglicized into "interest," derived from the Latin verb, *intereo,* meaning "to be lost." *Id.* at 73. While it was still assumed that the loan itself was to be made without charge, a practice developed, with the approval of both Church and secular authorities, of imposing a fine for the borrower's culpable delay (*mora*) in making timely payment. This fine, or *interesse,* was intended to compensate the lender for the harm suffered as a result of the lender's delay. Fisher, *supra,* at 5. Ultimately, the need to prove the wrongful conduct and the extent of the resulting loss were avoided by the use of two contract clauses -- one which released the lender from the burden of proving *mora*, and one which agreed upon a definite amount to be paid in indemnification. Thus interest became payable simply upon the showing of the delay in making payment, with separate fines agreed to for each period of delay. Böhm-Bawerk, *supra,* at 17; Fisher, *supra,* at 5.

"Interest" thus began to be viewed as compensation for the temporary loss of use of one's money, rather than an

unfair demand to be paid more than one had given. The French jurist Carolus Molinaues, writing in 1546, pointed out in detail how in almost every loan the lender experiences a loss - or "*interesse*" - whose compensation by the borrower is just and reasonable. He observed that the lender generally has a choice with regard to the money that he lends. Instead of lending it, he might elect to purchase land on which to grow crops, in which event he would receive the benefit of the land's bounty. Bohm-Bawerk, *supra*, at 20. Interest on the loan, then, is nothing more than a form of compensation for the loss suffered by the lender as a result of forgoing his own investment of the money. John Calvin, writing at roughly the same time, advanced similar arguments, asserting that lending at interest can be mutually beneficial to both the lender and the borrower. Harold J. Grimm, *The Reformation Era* 476 (2d ed. 1973).

It was precisely this mutually beneficial character of loan transactions that brought them into widespread use in post-Reformation Europe. In commercial centers, transactions involving interest became commonplace, and secular legislation condemning them yielded to practical necessity. With this as backdrop, in the Netherlands during the mid-seventeenth century, Claudius Salmasius articulated a comprehensive theory of interest that viewed it simply as compensation for the use of the money lent. He also undertook a systematic refutation of the canonist arguments against interest. In both respects, his contentions were well received by the commercial society in which he wrote. Böhm-Bawerk, *supra*, at 23-25.

Since the rise of capitalism -- and the attendant widespread reliance on commercial credit -- that accompanied the Reformation, there has ceased to be a serious question that

interest in some form (albeit often subject to regulation) would generally be accepted. The proposition that interest is a form of compensation paid to the lender by the borrower for the use of money has become fundamental and beyond serious dispute. This Court has recently acknowledged as much. *Smiley v. Citibank*, 116 S. Ct. 1730, 1735 (1996)("'Interest is the compensation allowed by law, or fixed by the parties, for the use or forbearance of money or as damages for its detention,'" quoting *Brown v. Hiatts*, 15 Wall. 177, 185 (1896)). From that proposition arises the necessary conclusion that interest paid is property *ab initio* of the lender.

B. The Force of This Basic Economic Principle Has Been Recognized Universally by the Courts

In determining that interest is the property of the party for the use of whose funds it is paid, the court below was not establishing some new rule of federal common law. Rather, the court was following a long-established common-law rule, adopted by Texas, that derives from an understanding of the economic principles described above.

The "interest follows principal" rule has been established under English common law since at least the mid-1700's. *See Beckford v. Tobin*, 1 Ves. Sen. 308, 27 Eng. Rep. 1049 (1749) ("interest shall follow the principal, as the shadow of the body"). Every state court that has addressed the issue has adopted the rule without reservation.[8] Prior to

[8] *See, e.g., Duren v. State*, 507 So.2d 111 (Ala. Crim. App. 1986); *Breda Construzioni Ferroviarie S.P.A. v. Los Angeles County Metropolitan Transp. Auth.*, 56 Cal. App. 4th 1433 (1997); *Burnett v. Brito*, 478 So.2d
(continued...)

the advent of IOLTA, Texas courts never displayed any hesitancy in adopting the "interest follows principal" rule. *Sellers v. Harris County*, 483 S.W.2d 242, 243 (Tex. 1972)("The interest earned by deposit of money owned by the parties to the lawsuit is an increment that accrues to that money and to its owners."); *Lawson v. Baker*, 220 S.W. 260, 272 (Tex. Civ. App.- Austin 1920, writ ref'd).

That principle has been repeatedly recognized in the decisions of this Court, beginning with *Himely v. Rose*, 9 U.S. (5 Cranch) 313, 319 (1809)(Johnson, J., dissenting) ("In equity, interest goes with the principal, as the fruit of the tree."), and continuing through *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 164 (1980). In *Webb's*, the Court held that "[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property." *Id.*

Webb's concerned interest generated by funds that had been deposited into the registry of a Florida court by the

[8](...continued)
845 (Fla. App. 1985); *Puckett v. Walker*, 21 S.E.2d 713 (Ga. 1942); *Kiernan v. Cleland*, 273 P. 938 (Idaho 1929); *B&M Coal Corp. v. United Mine Workers*, 501 N.E.2d 401 (Ind. 1986); *Rhea v. Brewster*, 107 N.W. 940 (Iowa 1906); *Vansant v. State*, 53 A. 711 (Md. 1902); *Adams v. Williams*, 52 So. 865 (Miss. 1910); *State Highway Comm'n v. Spainhower*, 504 S.W.2d 121 (Mo. 1973); *Siroky v. Richland County*, 894 P.2d 309 (Mont. 1995); *Bordy v. Smith*, 34 N.W.2d 331 (Neb. 1948); *State v. Erie*, 42 A.2d 759 (N.J. Super. 1945); *McMillan v. Robeson County*, 137 S.E.2d 105 (N.C. 1964); *Eshelby v. Cincinnati Bd. of Educ.*, 63 N.E. 586 (Ohio 1902); *Thompson v. Territory*, 62 P. 355 (Okla. 1900); *Southern Oregon Co. v. Gage*, 197 P. 276 (Ore. 1921); *Kann v. Kann*, 103 A. 369, 371 (Pa. 1918); *State v. Schamber*, 165 N.W. 241 (S.D. 1917); *State v. McLemore*, 37 S.W.2d 103 (Tenn. 1931); *Heck & Paetow Claim Service, Inc. v. Heck*, 286 N.W.2d 831 (Wis. 1980).

buyer of an insolvent company.[9] The court in turn deposited the funds in an interest-bearing bank account. Acting in accordance with a state statute, the clerk of the court deemed interest earned on the account to be property of the court. *Id.* at 158. This Court recognized that fund claimants had no absolute right to payment of interest because they had no right to insist that the registry funds be deposited in an interest-bearing account. *Id.* at 161-162. The Court nonetheless held that, for purposes of Takings Clause analysis, any interest actually earned should be deemed the property of the fund claimants. *Id.* at 161. *See also, United States v. Mosby*, 133 U.S. 273, 286 (1890)(trustee "was not required to put the funds out at interest, but if he did so, the accretion belonged to the [trust beneficiary]").

Petitioners and their supporting *amici* repeatedly cite the statement in *Webb's* that "a mere unilateral expectation or an abstract need is not a property interest entitled to protection." *Webb's*, 449 U.S. at 161. But surely, in light of the universal acceptance -- both in Texas and elsewhere -- of the common law rule that the earnings of a fund are property just as the fund is property, Respondents' desire to retain the

[9] The buyer was acting pursuant to the Florida Bulk Transfers Act, Fla. Stat. § 676.106(4) (1977), which permitted buyers of insolvent companies to protect themselves by filing an interpleader complaint in state court and depositing the entire purchase price with the court registry. The law provided that once an interpleader action was filed, those with claims against the insolvent company were required to seek compensation from the interpleaded fund rather than from the buyer. 449 U.S. at 156 & n.2. In *Webb's*, nearly 200 creditors ended up filing claims against the fund. *Id.* at 157.

interest earned on their funds cannot be deemed a "unilateral expectation."[10]

In an effort to distinguish *Webb's*, Petitioners attempt to contrast the amount of interest at stake there (approximately $100,000) with the interest generated by each attorney participating in the Texas IOLTA program. Pet. Br. at 26-27. Petitioners fail to mention, however, that there were 200 claimants to the interest at stake in *Webb's*, 449 U.S. at 157, and the Court never suggested that Florida might withhold interest from those creditors with small claims on the ground that such creditors could not have generated net interest on their own. Indeed, this Court has squarely rejected creation of a *de minimis* exception to the Takings Clause: when the government appropriates private property for itself, compensation is required "no matter how minute the intrusion, and no matter how weighty the public purpose behind it." *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003, 1015 (1992).

In support of Petitioners' position, the United States cites a series of Takings Clause cases in which the Court has

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[10] Respondents' expectation that they would receive interest generated from their funds was, in fact, greater than the expectation of the plaintiffs in *Webb's*. Petitioners have never contested that clients who place funds in trust with their attorneys are the sole equitable owners of those funds. In contrast, at the time that the fund at issue in *Webb's* was generating interest, the plaintiffs had merely filed claims against the fund, and their claims had not yet been acted upon in state-court interpleader proceedings. This Court nonetheless recognized that the plaintiffs' expectations that they eventually would receive a distribution from the interpleaded fund if their claims were allowed, and that they would receive a proportionate share of any interest generated by the fund (despite a state statute to the contrary), were property rights cognizable under the Takings Clause. 449 U.S. at 161-162.

considered how to compute the value of real property taken by the government. U.S. Br. at 19-24. These cases stand generally for the proposition that the value of real property taken by the government should be computed based on the loss suffered by the property owner, not the benefit derived by the government. *See, e.g.*, *United States v. Miller*, 317 U.S. 369, 375 (1943); *Olson v. United States*, 292 U.S. 246, 255 (1934).[11] None of those cases are relevant to the issue now before the Court: whether the interest earned on IOLTA accounts is the property of those whose property generated the interest. If, as *Webb's* indicates, the interest *is* the property of IOLTA depositors and a compensable taking has occurred, then there should be little difficulty placing a value on what is at stake: it is the amount of the interest paid by the bank and taken by the government.[12]

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[11] The argument of the United States that IOLTA programs are profitable because Texas and other states have added value and that "IOLTA interest is the product of the government's pooling of funds" (U.S. Br. at 20) suggests a fundamental misunderstanding of how IOLTA programs operate. Texas does not engage in any "pooling of funds." Rather, it is individual attorneys who pool their client trust funds in a single account. The sole role played by Texas is to demand that interest earned on such accounts be given to TEAJF rather than being used, for example, to defray the costs of operating the account.

[12] The United States also argues that IOLTA interest is not the property of IOLTA depositors because they had "no reasonable, investment-backed expectation that their funds would generate interest." U.S. Br. at 12-19. That argument is based on a misreading of relevant case law. The concept of "reasonable, investment-backed expectations" comes into play, if at all, in determining whether government *regulation* of private property is compensable under the Takings Clause. *See, e.g., Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005-1006 (1984). That concept is irrelevant to the antecedent determination of whether the claimant has cognizable property rights in the property at issue. *Id.* at 1001.

(continued...)

Respondents recognize that when the government is administering a fund, it is permitted to charge a reasonable fee for its services. *Webb's*, 449 U.S. at 162-163. But Texas has never attempted to characterize its 100% appropriation of funds earned on IOLTA accounts as a fee for its administration of those funds; rather, it justifies its appropriation by contending that IOLTA depositors lack any property rights in IOLTA interest. Nor have Petitioners sought to characterize IOLTA as a tax or a "users' fee" on users of the legal system. That clearly was not Petitioners' rationale in establishing the IOLTA program. If it were, it would be arbitrary indeed, because it falls haphazardly on those who place small sums in the hands of their lawyers, and not on others who place larger sums, or on those who make extensive use of the legal system yet find no need to put money into the custody of their lawyers.

In sum, the doctrine that "interest follows principal" is a universally accepted principle of property law throughout the United States, including within the State of Texas. As the Court recognized in *Webb's*, the principle is fully applicable regardless whether the owner of the property had a right to insist that interest be generated by his funds, regardless of the amount of interest at issue, and regardless

[12](...continued)

The United States's reliance on trust law for the proposition that attorneys as trustees are under no duty to make productive use of trust assets (U.S. Br. at 14) similarly misses the mark. Trust law is clear that regardless whether a trustee is under any obligation to invest trust funds for a profit, if he actually does so any profits earned belong to the beneficiary. *See* 2 A. Scott, *The Law of Trusts* § 181 (3d ed. 1967). *See generally*, C. Rounds, *Social Investing, IOLTA and the Law of Trusts: The Settlor's Case Against the Political Use of Charitable and Client Funds*, 22 Loy. U. Chi. L.J. 163 (1990).

whether the owner had a "reasonable, investment-backed expectation" of receiving interest. That principle is controlling in this case. The interest actually generated by Respondents' trust funds is their property, for purposes of Takings Clause analysis, whether or not they would in fact have received interest on it in the absence of IOLTA.

C. Texas May Not Evade Takings Clause Review by Abrogating the Interest-Follows-Principal Rule for the IOLTA Program and in No Other Contexts

While Petitioners concede that Texas property law generally adheres to the rule that interest belongs to the owner of the property that generated it, they assert that Texas has the right to alter its property law as it sees fit. Petitioners note that the Supreme Court of Texas has declared, as a matter of Texas law, that interest generated by IOLTA accounts belongs to TEAJF, not to the owner of the funds that generated the interest. Pet. Br. at 9. Accordingly, Texas and its supporting *amici* argue, the Takings Clause is inapplicable to this case because none of Respondents' "private property" (as defined by state law) can be said to have been taken. *See, e.g., id.* at 21-23; Br. of Conference of Chief Justices at 29.

It is true that "[p]roperty interests . . . are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law." *Webb's*, 449 U.S. at 161 (quoting *Roth*, 408 U.S. at 577). However, *Webb's* went on to explain:

> [A] State, by *ipse dixit*, may not transform private property into public property without compensation,

> even for the limited duration of the deposit in court. This is the very kind of thing that the Taking Clause of the Fifth Amendment was meant to prevent. That Clause stands as a shield against the arbitrary use of governmental power.

Webb's, 449 U.S. at 164. *See also, Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 439 (1982)("the government does not have unlimited power to redefine property rights").

Accordingly, a state may not evade Takings Clause restrictions by simply declaring that property it covets is no longer privately owned. "Property" is an evolving concept, and states are empowered to modify from time to time "the bundle of rights" that are commonly characterized as property. *Lucas*, 505 U.S. at 1027-1028. But any such modifications must be consistent with "background principles of . . . property law" that remain in place following the modification. *Id.* at 1031. A state may not, as Texas seeks to do in connection with the IOLTA program, eliminate centuries-old property rights for one small class of individuals while continuing to recognize such rights for others (including the state itself) that are similarly situated. Any such state effort can fairly be categorized as an "*ipse dixit*" and thus does not diminish the Fifth Amendment claims of those objecting to the state's actions.

Webb's makes clear that such *ipse dixits* are suspect regardless whether a state acts retroactively, or prospectively only, in redefining property rights. Indeed, the Florida statute at issue in *Webb's* was a prospective statute: it applied only to interest generated *after* the statute had been adopted. The Court nonetheless branded as an "*ipse dixit*"

Florida's pronouncement that interest earned on privately owned court-registry funds was "public money," in light of background principles of property law to the contrary. *Webb's*, 449 U.S. at 163-164. Thus, it is no defense for Texas to assert that the IOLTA program was already in place at the time Respondents' funds were deposited in attorney trust accounts.

The Texas IOLTA Rules seek to decree that owners of funds placed into IOLTA accounts lack any state-law property rights in interest generated by those funds. No other category of Texas property owners is similarly disfavored. To the contrary, with the exception of the IOLTA program, Texas (along with every other state) has consistently adhered to the interest-follows-principal rule. *Sellers*, 483 S.W.2d at 243; *Lawson*, 220 S.W. at 272. The order declaring that IOLTA interest does not belong to the owners of the principal provided no explanation, other than a desire to facilitate TEAJF's compliance with federal banking laws.[13] Under *Webb's*, such unprincipled efforts to transform private property into public property do not deprive objecting property owners of their rights to recourse under the Fifth Amendment.

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[13] The Supreme Court of Texas's July 1, 1985 order, which addressed ownership of IOLTA interest (*see* Pet. Br. at 9 n.9), provided that the court's 1984 order establishing the IOLTA program be amended by adding the following paragraph:

> It is further ordered that the Texas Equal Access to Justice Foundation shall hold the entire beneficial interest in the interest generated by and paid to the Foundation by each trust account established pursuant to Article XI of the State Bar Rules so as to make such accounts eligible under 12 U.S.C. Section 1832(a)(2) for placement in NOW and Super NOW accounts.

Indeed, despite its current litigation posture, Texas in several recent cases has invoked the interest-follows-principal rule to win the right to collect interest under circumstances highly analogous to those faced by Respondents. The two cases, *Matter of Al Copeland Enterprises, Inc.*, 991 F.2d 233 (5th Cir. 1993), and *In re Megafoods Stores, Inc.*, 210 Bankr. 351 (B.A.P. 9th Cir. 1997), both involved efforts by the State of Texas to recover sales tax receipts (plus interest) collected by companies that filed Chapter 11 bankruptcy petitions. Under Texas law, the debtors were deemed to hold those receipts in trust for the State. TEX. TAX CODE ANN. § 111.016 (Vernon 1992). Accordingly, the debtors were ordered to turn the sales tax receipts over to Texas (pursuant to Texas trust law), rather than to hold the funds as part of the bankruptcy estate for the benefit of all unsecured creditors. *Copeland,* 991 F.2d at 235; *Megafoods,* 210 Bankr. at 356.

The next issue in both cases was, who was entitled to the interest earned on the trust funds while they were in the possession of the debtors? Texas conceded that, under its sales tax laws, it had no right to demand interest on the sales tax trust funds during the first 60 days that payment was delinquent; nor does federal bankruptcy law provide for payment of interest on allowed claims. The courts nonetheless agreed with Texas's argument that it was entitled, *as a matter of Texas trust law*, to recover the interest that in fact had been earned on the trust funds during the first 60-day period they were held by the debtors. *Copeland,* 991 F.2d at 236-37; *Megafoods*, 210 Bankr. at 358-59. As the Ninth Circuit Bankruptcy Appellate Panel explained:

> The reason the State is entitled to the 4% rate of interest actually earned is because under state trust law, *earnings* on property held in trust for another (i.e., the trust fund monies) are as much the property of the person for whom the trust monies are held as are the trust monies themselves.

Id. at 359 (emphasis in original).

The parallels between *Copeland* and *Megafoods* and this case are striking. Respondents are the beneficial owners of trust funds that are generating interest, as was Texas in *Copeland* and *Megafoods.* Neither Texas nor Respondents rested their claim on an asserted right to insist that the funds be deposited in an interest-generating account. Texas nonetheless persuaded two federal appellate panels that it was entitled, as a matter of Texas law, to recover the interest actually earned on its trust funds because "*earnings* on property held in trust for another . . . are as much the property of the person for whom the trust monies are held as are the trust monies themselves." *Megafoods,* 210 Bankr. at 359. Having successfully invoked state law to win the interest generated by *its* trust funds, Texas can articulate no principled basis for denying equal treatment for Respondents.

While conceding that Texas law adopts the interest-follows-principal rule in many cases, Petitioners insist that Texas has always recognized exceptions to the rule -- and that the IOLTA program simply creates one more exception. Pet. Br. 22-23.

The cases cited by Petitioners do not support their argument. *Price v. Austin Nat'l Bank,* 522 S.W.2d 725 (Tex. Civ. App.-Austin 1975, writ ref'd n.r.e.), merely recognized that the settlor of a trust is entitled to name the

beneficiaries of his trust, and that the power to do so includes the power to grant trust income to one person and to direct, upon that person's death, that the trust corpus be distributed to another. Granting such power to those creating trusts is not an exception to the interest-follows-principal rule; in such cases, the ultimate beneficiary of the trust corpus has not been granted an undivided interest in the corpus and thus simply is not in a position to invoke the interest-follows-principal rule.

The various community property cases cited by Petitioners are similarly unhelpful to their position. Texas community property law provides that when a man and a woman enter into a marriage contract, separate property brought into the marriage by one spouse continues to be the separate property of that spouse. *See, e.g., Arnold v. Leonard,* 273 S.W. 799 (Tex. 1925). But any interest or revenues derived from the spouse's separate property during the marriage are deemed community property. *Id.* at 803. Texas courts have never described this community property rule as an exception to the interest-follows-principal rule. Rather, it can best be understood as an effort to read an implied term into the marriage contract: one entering voluntarily into a marriage agrees to convey to his/her spouse one-half of all income derived from one's separate property. The interest-follows-principal rule has never been understood to prevent the owner of the principal from agreeing to convey a portion of his interest income to another.

Even if the cited cases were recognized as exceptions to the interest-follows-principal rule, they do not sufficiently alter "background principles of . . . property law" (*Lucas*, 505 U.S. at 1031) such that the exception created by the IOLTA program could be seen as anything other than an

ipse dixit. For example, the rule providing that income earned during a marriage is community property even when derived from the separate property of one spouse, hardly establishes "background principles of . . . property law" so as to justify creation of the IOLTA program; one cannot derive from that rule a principle whereby the state is permitted to declare that those who place funds in trust with their attorneys are required to relinquish to *the state* their *entire* rights to interest on those funds.

Texas cannot evade Takings Clause review of its IOLTA program by simply declaring that interest earned on IOLTA accounts is no longer to be deemed private property under Texas property law. As *Webb's* instructs, "the Takings Clause of the Fifth Amendment was meant to prevent" just such attempts to "transform private property into public property without compensation." 449 U.S. at 164.

D. Government Regulation of Interest and Interest Rates Do Not Negate a Fund Owner's Property Right in the Income It Produces

Petitioners and several of their supporting *amici* further miss the mark in this case with their fixation on pervasive government regulation of interest and interest rates. *See* Pet. Br. at 20; U.S. Br. at 9-19; ABA Br. at 12-14. As discussed in Part I.A., *supra*, it is true that governments have regulated the payment of interest for nearly as long as credit has existed. *See, e.g.*, Homer & Sylla at 26. But any such regulation says nothing about the right of a depositor to the interest that a bank actually *pays*.

Indeed, this Court's cases have suggested that the government's power to regulate a commercial activity does

not permit the government to seize, without compensation, income generated by that activity. In *Webb's*, as discussed, the Court recognized the right of owners of a fund to receive the interest a bank paid for the use of the fund, even though the owners had no right to demand that the fund be deposited in an interest-bearing account, and even though the deposit was subject to a broad range of federal and state regulatory measures. *Webb's*, 449 U.S. at 162. Analogously, this Court has on numerous occasions affirmed rent control ordinances without doubting for a moment the right of the property owner to the rent actually paid. *See, e.g.*, *Pennell v. City of San Jose*, 485 U.S. 1 (1988) (upholding rent control ordinance against a due process challenge); *Block v. Hirsh*, 256 U.S. 135 (1921) (upholding District of Columbia rent control law). Thus, this Court has plainly recognized that whether a property right exists is analytically distinct from whether the government may regulate the property.

Failing to grasp that distinction, Petitioners and their *amici* assert that Respondents are seeking compensation for interest income on the ground that they would have been able to earn it in the absence of government regulation of interest rates. *See* Pet. Br. at 20; U.S. Br. at 18-19, 22 n.19. They proceed as if Respondents have brought this suit against either (a) a bank regulator that refuses to allow Respondents' money to earn interest pursuant to a federal regulation; or (b) a bank that refuses to pay for the use of Respondents' money. Against such fictional challenges the United States triumphantly asserts that "the ability to obtain interest has never been understood as an entitlement or a right" (*id.* at 16) and that, given the long history of government regulation of the banking industry, "Respondents could [not] reasonably expect" that interest would be paid on their

funds. *Id.* at 19. If the United States means that the ability of a claimant to recover interest *actually paid* on his principal is not an entitlement or right, it is obviously wrong in view of *Webb's*. All that the United States has demonstrated is that a bank is not required to pay interest on a deposit unless it agrees to do so or the law compels it to do so -- a proposition Respondents do not challenge.

Respondents, of course, brought this case not against a bank, but against TEAJF, which has appropriated interest that a bank *has* paid for the use of Respondents' money. Respondents sued because the State of Texas forced the bank to pay TEAJF instead of Mr. Summers for the use of his money. The government's asserted power to prohibit the bank from paying any interest at all does not negate Mr. Summers's right to the interest the bank actually did pay.

At root, the arguments of Petitioners and their *amici* rest on a conception of interest as "government-created value" (U.S. Br. at 19-20) -- a property right that exists only at the sufferance of the government and only because it is created due to the workings of a government regulatory scheme. But the property rights at issue in this case are not dependent, as in *Board of Regents v. Roth*, on a government-created program that confers specific benefits on individuals. 408 U.S. at 577. Rather, the property rights arise because banks are ready, willing, and able to pay for the use of money owned by Respondents. While federal and state governments are empowered to regulate the circumstances under which interest is to be paid, *Webb's* dictates that any interest actually earned belongs to Respondents because "[t]he earnings of a fund are incidents of ownership of the fund itself." *Webb's*, 449 U.S. at 164.

II. VIRTUALLY ALL CLIENTS WOULD BENEFIT FINANCIALLY IF THEIR FUNDS WERE KEPT OUT OF THE IOLTA PROGRAM

For the reasons stated above, clients who place short-term and nominal deposits with lawyers have the same expectations as other depositors: they expect to receive any interest that is paid for the use of their money. Where interest is in fact paid, it is irrelevant for purposes of Takings Clause analysis whether the money could have earned interest if placed instead in an account for the benefit of the client.

However, the Court should affirm even if it determines, as urged by Petitioners, that the existence of a property right in IOLTA interest hinges on whether the Texas IOLTA program takes from clients income that they would have received were there no IOLTA program. Evidence in the record indicates that, virtually always, clients benefit if their trust funds are deposited into interest-bearing non-IOLTA accounts. J.A. 98-99. Because the IOLTA Rules prohibit such deposits in many instances, they impose a very real financial burden on clients. In addition, given the vague, obscure, and many-layered character of the Texas IOLTA Rules, it is inevitable that many lawyers put client money into IOLTA accounts out of uncertainty about what the Rules require.

A. The Record Indicates That Almost All Client Deposits Are Capable of Earning Interest for the Client, but in a Manner That the IOLTA Rules Foreclose

This case comes before the Court on review of a grant of summary judgment for Petitioners, which was reversed by the Fifth Circuit. In reviewing a lower court's decision on a motion for summary judgment, a court must view the facts in the light most favorable to the non-moving party. *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 456 (1992). That includes accepting factual assertions contained in the affidavits of the non-moving party's experts. *Id.*

In the district court, Respondents submitted an affidavit from Robert J. Randell, a New York attorney and an expert on escrow management and IOLTA practices. In his affidavit, Mr. Randell stated, "It is common knowledge that today, interest net of any fees can be earned on virtually *all* client funds through bank sub-accounting." J.A. at 98.[14]

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[14] In the context of attorney trust funds, bank sub-accounting is a practice whereby a lawyer opens under each client's name and tax identification number an interest-bearing account under the umbrella of, and linked electronically with, the lawyer's main trust account. J.A. 100. The interest accrues to each sub-account separately, thereby eliminating any requirement that the attorney himself allocate total interest earned among clients whose funds are in the account. *Id.* Sub-accounting services also include the IRS reporting tasks associated with each client's sub-account. *Id.* at 98-99. Mr. Randell's affidavit attaches exhibits from two banks (including one with a large Texas presence) that provide these services free of charge.

In addition, Mr. Randell explained why use of these bank sub-accounting services can be *less* expensive than use of an IOLTA account:

> [A]n attorney has a fiduciary obligation to keep detailed accounting records of the history of each client's separate fund. With bank sub-accounting all the arithmetic is done by the depository. Running balances with accrued interest are maintained for each client's fund and are shown on monthly statements. Year-end IRS 1099's are provided as well, without charge. The attorney will spend less of his own time in general escrow administration using bank sub-accounts than if he maintains a pooled IOLTA account. With an IOLTA account, it is left to the attorney alone to compute what each client has in the account and to make sure the total of the individual client deposits coincides with the IOLTA total.

J.A. 98.

Notwithstanding the practical availability of these procedures, their use is prohibited by the rules governing IOLTA accounts in many instances. The IOLTA Rules direct attorneys to consider whether a non-IOLTA account could generate "net interest" for the client, *not* whether the client would be better off if his/her funds were placed in a non-IOLTA account rather than in an IOLTA account. *See* IOLTA Rule 6. As Mr. Randell stated, the administrative costs of maintaining a non-IOLTA account are no higher (and, in some instances, may be lower) than the administrative costs of maintaining an IOLTA account. J.A. 98. Yet, whenever (as will often be true) a client's per capita share of the total administrative and overhead costs of maintaining

an interest-bearing account would be greater than his share of interest generated from that account, IOLTA Rule 6 requires that such funds be placed into an IOLTA account. The net result, from the client's perspective, is that interest generated by his funds is paid to TEAJF rather than being used to defray the costs of maintaining the trust account.

Moreover, there is considerable question regarding whether IOLTA Rule 6 even permits attorneys to employ sub-accounting when determining whether client funds may be kept out of the IOLTA program. Rule 6 provides that the lawyer must consider whether each client's deposit can earn interest net of enumerated costs "*without regard to funds of other clients which may be held by the attorney.*" (Emphasis added.) On its face, this restriction appears to prohibit pooling client funds in non-IOLTA accounts. Further, in literature distributed to Texas attorneys throughout much of the Texas IOLTA program's existence, TEAJF officials have repeatedly interpreted Rule 6 as requiring the maintenance of a separate account for each client whose funds the attorney desired to keep outside the IOLTA program. *See, e.g.*, S. Peterson and W.F. Newton, *Trust Accounts and the New Comprehensive Interest on Lawyers' Trust Accounts Rule*, 52 Tex. Bar J. 590 (May 1989).[15]

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[15] As noted above, *supra* at 5 n.1, Petitioners have apparently abandoned that position in this litigation. In the Fifth Circuit, Petitioners stated that they now interpret Rule 6 as permitting sub-accounting in connection with non-IOLTA trust accounts, provided that use of such accounts is otherwise permissible under the Rule. *Id.* Given the quoted language from Rule 6 and the minimal likelihood that Texas lawyers are familiar with Petitioners' litigation position, however, at the very least they will be uncertain about whether they can pool client funds in non-IOLTA accounts in order to defray account maintenance costs. Further, as the Court (continued...)

The evidence submitted by Respondents indicates that virtually all clients whose funds are deposited into attorney trust funds would benefit financially if those funds were placed in non-IOLTA interest-bearing accounts, but that Texas requires attorneys to deposit the funds of many such individuals into IOLTA accounts. Accordingly, even if the Court accepts Petitioners' contention that a Takings Clause cause of action requires a showing that Respondents could have benefitted financially in the absence of the IOLTA program, the Fifth Circuit's decision reversing the grant of summary judgment should be affirmed.

B. The Texas IOLTA Rules Are Complex and Vague and Thus Do Not Effectively Protect Clients' Rights To Interest Generated by Their Funds

Any lawyer seeking to serve his client by using trust funds to generate interest income for the client faces a daunting task. The Texas IOLTA rules are complex, multi-layered, and highly confusing; they do not give reasonable guidance to lawyers who must decide what to do with client funds. At the same time, TEAJF and Texas State Bar officials have been urging attorneys for years to demonstrate their commitment to "equal access to justice" by maximizing IOLTA participation. *See, e.g.*, C. Smith, *IOLTA: A No Lose Program*, 48 TEX. BAR J. 752 (July 1985). And the rules provide lawyers with immunity so long as they act in good faith. IOLTA Rule 23, J.A. 121. The net result is to

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[15](...continued)
noted last term, a party's submissions regarding statutory scope that are contrary to the text of the statute are not especially meaningful. *Reno v. ACLU*, 117 S. Ct. 2329, 2349 (1997).

systematically tilt the scales in favor of placing client funds into IOLTA accounts rather than investing them for the benefit of the client, and to appropriate income to the State which could practicably accrue to the benefit of the client.

Texas maintains three sets of vague and somewhat-contradictory rules governing client trust funds. Texas Rule of Professional Conduct 1.14(a), which governs the safe-keeping of client property, states in relevant part that "[s]uch funds shall be kept in a separate account, designated as a 'trust' or 'escrow' account. . . ." However, the rule does not specify into what type of account client funds should be deposited, and it is silent regarding whether the attorney should seek to earn interest on the account.

The maintenance of attorney trust accounts is also addressed by the rules establishing the Texas IOLTA program: Article XI of the State Bar Rules. Article XI, § 5(A) provides that attorneys are to maintain an IOLTA account into which they are to deposit "client funds that are nominal in amount or are reasonably anticipated to be held for a short period of time." It further provides that the IOLTA account is to be an "interest-bearing demand account at a financial institution," but does not define the term "demand account." Article XI goes on to provide that nothing contained therein should be construed to prohibit attorneys from depositing client funds into non-IOLTA "interest-bearing accounts or other investments permitted by the Texas Code of Professional Responsibility," with interest payable to the client. Art. XI, § 5(B). Section 5(B) is silent regarding what types of "interest-bearing accounts" and what "other investments" are permissible.

Yet a third set of rules governing client trust funds is the IOLTA Rules. J.A. 108-125. IOLTA Rule 4 provides that IOLTA funds (i.e., "client funds that are nominal in amount or are reasonably anticipated to be held for a short period of time") must be deposited in an "interest-bearing insured depository account at a financial institution." J.A. 111. Rule 7 provides that this IOLTA account must be one "from which withdrawals or transfers may be made on demand" and must be established in a federally or state-insured "bank, credit union or savings and loan association." As is true of the other two sets of rules, the IOLTA Rules provide no guidance regarding the types of accounts into which non-IOLTA trust funds are to be deposited.

For guidance regarding whether or not client funds are "nominal" or "short[-term]," and thus must be deposited into an IOLTA account, attorneys must look to Rule 6. J.A. 113-14. Rule 6 requires client funds to be placed in IOLTA accounts:

> [I]f . . ., considered without regard to funds of other clients which may be held by the attorney, . . . the interest which might be earned on such funds is not likely to be sufficient to offset the costs of establishing and maintaining the account, service charges, accounting costs and tax reporting costs which would be incurred in attempting to obtain interest on such funds for the client. Also to be considered are the nature of the proceeding or transaction involved and the likelihood of delay in the need for such funds in such proceeding or transaction.

The Rules provide no further guidance regarding how attorneys are to undertake the complex financial calculations outlined in Rule 6.[16]

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[16] Guidance documents issued by TEAJF are similarly vague, but TEAJF officials have used the occasion to provide a none-too-subtle message that non-IOLTA accounts entail quite high administrative costs and thus should be used sparingly. For example, excerpts from Peterson and Newton, *supra* (reprinted as a four-page TEAJF guidance document for lawyers, entitled "The Mechanics of IOLTA"), warns that "all costs associated with" a non-IOLTA account "will be either directly or indirectly passed on to the client, so the client's separate [non-IOLTA] account must earn enough to justify its existence." Peterson and Newton, *supra*, at 591. The document states that "cost factors" to consider in determining whether client funds can generate net interest "include":

> Internal costs:
>
> 1. the expense of the attorney's or law firm's staff time in establishing the separate account
> 2. the preparation and filing of tax forms relating to the account to the IRS (e.g. IRS 1099 forms)
> 3. the bookkeeping and accounting expenses for tracking the account
> 4. the monthly reconciliation of the account for the client
> 5. closing the account at the bank and remitting the funds to the client
>
> External costs:
>
> 1. the minimum balance requirement at the bank at which the account is placed
> 2. the service charges, if any, assessed against the account by the bank
> 3. other additional fees that the bank may have for investment policies.

Id.

Compounding the difficulty of the task required of attorneys by Rule 6 is the failure of the any of the three sets of rules enumerated above to specify the types of interest-bearing accounts into which non-IOLTA trust funds may be placed. Current interest rates on NOW accounts of around 1 1/2% per annum are far lower than rates available on savings accounts and money market accounts. Thus, the ability of client funds to generate "net interest" varies widely depending on the type of account into which they are deposited, yet Texas rules provide virtually no guidance regarding the type of account to be used for non-IOLTA funds.[17]

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[17] Some of Petitioners' supporting *amici* suggest that the IOLTA Rules require that attorneys place *any* attorney trust funds, whether IOLTA or non-IOLTA, into NOW accounts. *See, e.g.*, U.S. Brief at 3; ABA Brief at 7, 8 n.9. Petitioners' brief hints that they may support that contention. *See, e.g.*, Pet. Brief at 5. The apparent purpose of this contention is to suggest that those clients who do not qualify for NOW accounts (e.g. for-profit corporations) could never earn interest for themselves on funds they deposit with their attorneys, no matter how large those deposits happen to be.

However, nowhere do either Article XI or the IOLTA Rules state that *any* attorney trust funds must be deposited in NOW accounts. Dealing only with IOLTA funds, Article XI, §5 requires only that they be placed in a "demand account," and there is no parallel requirement for client funds deposited in non-IOLTA accounts. While the term "demand account" is not defined in either Article XI or the IOLTA Rules, Respondents are unaware of *any* definition of "demand account" that would include NOW accounts but would exclude savings accounts on which corporations can earn interest. Under federal banking regulations, a "demand deposit" (on which banks are prohibited from paying interest, *see* 12 U.S.C. § 371(a)), includes checking accounts, but does *not* include savings accounts *or* NOW accounts. 12 C.F.R. §§ 204.2(b)(1), (b)(3)(i), and (b)(3)(ii).

Article XI, § 5 uses the term "demand account" in its more commonly understood sense: an account that permits depositors near-immediate access

(continued...)

If an attorney has many clients for whom he holds money in trust, it may occur to him to pool that money in one interest-bearing account and sub-account each client's interest to save costs. While such a course appears to be consistent with the Texas Rules of Professional Conduct, as discussed above (***see supra*** at 40-41) it is inconsistent with the literal language of IOLTA Rule 6. Petitioners' apparent abandonment of Rule 6's literal language during the course of this litigation does not ameliorate the impact of the rule on lawyers faced with choices about the disposition of client funds. There is every reason to expect that lawyers will continue to believe, with Respondent Mazzone, that the relevant issue under IOLTA Rule 6 is whether a client's funds can generate net interest when a separate account is opened for those funds.[18]

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[17](...continued)

to their funds. IOLTA Rule 7 requires IOLTA funds to be placed in an account "from which withdrawals or transfers may be made on demand (subject only to any notice period which the financial institution is required to reserve by law or regulation) . . .," thus indicating that payment on "demand" refers to ease of access to funds, not to check-writing privileges. Indeed, both IOLTA Rule 8 and Article XI, §6 make clear that even time-deposits, such as certificates of deposit, may be used for IOLTA accounts under certain circumstances. And IOLTA administrators, both in Texas and elsewhere, have actively encouraged attorneys to place their IOLTA funds in accounts that pay higher rates of interest than do NOW accounts.

Accordingly, attorneys are permitted to deposit client trust funds in investment vehicles other than NOW accounts. The virtually exclusive focus of Petitioners and their *amici* on NOW accounts is therefore not justified. But their misreading of the relevant rules well illustrates the confusing nature of those rules.

[18] *See* Affidavit of Respondent Mazzone, J.A. 83. Mr. Mazzone's statement that funds entrusted to him by clients often were unable to generate

(continued...)

In sum, the regulations surrounding the administration of the IOLTA program create great uncertainty about the obligations of lawyers who are ultimately responsible for its implementation. Little guidance is provided regarding how to determine whether trust funds are likely to generate net interest, and the kinds of bank accounts (or other investments) lawyers should or must consider. In the face of such uncertainty and of TEAJF's insistence that the administrative and overhead costs of operating non-IOLTA accounts are quite high, the natural instinct of any lawyer confused (quite understandably) about his obligations is to deposit virtually all trust funds into an IOLTA account. The inevitable effect of the maze of vague and complex Texas IOLTA rules, then, is to steer into IOLTA accounts substantial amounts of attorney trust funds that could have generated net interest for their owners.

III. THE COMPUTER REVOLUTION CONFIRMS THAT THE EXISTENCE OF A PROPERTY INTEREST SHOULD NOT TURN ON THE AVAILABILITY AND COST OF FINANCIAL ACCOUNTING SERVICES.

Petitioners go to great pains to show that the organized bar and the banking world could not conceive in the early 1980's how short-term and nominal client deposits could ever earn *any* interest. *See* Pet. Brief at 4-8. The advent of the NOW account provided a practical way to collect interest on qualified checking account deposits. Sub-

[18](...continued)
net interest when deposited in a separate account (¶ 4) was written in 1994, *before* Petitioners announced in the Fifth Circuit that they had reinterpreted IOLTA Rule 6.

accounting, of course, represented a further advance in banking practices and computer technology, albeit only a modest one. *See* J.A. at 100.

Beyond these relatively narrow developments, revolutionary advancements in computers and information technology also bear strongly on the issue before the Court. Since the birth of the IOLTA concept in the 1980's, the cost of performing complex calculations has plummeted exponentially, and the speed with which we are able to do so has moved as fast in the opposite direction. The utilization of computer equipment to perform the kinds of functions that Petitioners make the centerpiece of their brief has gone from uncommon to universal. In 1984, the year Texas first promulgated its IOLTA program, IBM compatible computers were available with 256 kilobytes of memory, 10 megabytes of internal storage, and 8 MHz of processor speed. "Buyer Guide," *PC Week*, Feb. 28, 1984, 34-35. For a basic 1984 PC, the price was around $2,700, and PCs with added power and speed cost considerably more. *Id.* For about half that price today, one can purchase a computer with 60 times the memory and nearly 350 times the internal storage, working 25 times faster than the most advanced PCs available in 1984 -- with a long list of features enhancing its ease and effectiveness of use. *See* THE COMPUSA PC. THE CHOICE IS YOURS, *The Wall Street Journal* (Sept. 25, 1997) A21 (advertisement).

These advances in technology bear out Moore's Law (named for Gordon Moore, cofounder of Intel), that the memory capacity of computer chips doubles every 18 months. This has been the experience since 1965, and Microsoft founder Bill Gates predicts that Moore's Law will hold for another twenty years or so. Bill Gates, *The Road*

Ahead, at 35-36 (1996). "If it does, a computation that now takes a day will be more than 10,000 times faster and thus take fewer than ten seconds." *Id.* at 36.

As Federal Reserve Chairman Alan Greenspan recently acknowledged, relentless advancements in computer technology have "lowered the costs, reduced the risks, and broadened the scope of financial services," resulting in increased competition in the financial services industry. *Remarks by Alan Greenspan at the Annual Convention of the American Bankers Association,* (visited Oct. 7, 1997) <http//www.bog.frb.fed.us/BOARDDOCS/SPEECHES/19971005.htm> (given on Oct. 5, 1997 at Boston, Mass.). Indeed, technology and competition have combined to make the software necessary to perform many complex banking tasks so inexpensive that much of it is available for free. *See, e.g., "Chevy Chase Offers Direct Touch Banking,* The Washington Post (Sept. 25, 1997) A15 (advertisement). *See generally,* Douglas Goldstein and Joyce Flory, *The Online Business Guide to Financial Services,* 110-123 (1997).

All of these developments serve not merely to alter, but to revolutionize overnight, the reasonable expectations of parties in countless specific subject areas. Yet, the Texas IOLTA program has failed to keep pace with these changes. The IOLTA Rules were promulgated at a time when the abilities and costs of banks and attorneys to perform accounting functions seemed to some predictable and fixed, and the only functional way a lawyer could keep a client's funds readily available was through a checking account

(which could not earn interest).[19] To continue an IOLTA program at a time when technological advances have made it possible for clients virtually always to benefit from the use of their trust funds (J.A. 98) makes little sense. Continuation of the program and the active promotion of its use conveys the false impression to lawyers that there is no way for their clients to benefit from the use of their trust funds.

Surely the existence of a constitutional property interest cannot depend on the state of banking services in the mid-1980's when IOLTA was initiated. Nor should it rest on moment-by-moment monitoring of the computer revolution to determine the precise moment when technological advances permit attorneys to generate net interest on nominal and/or short-term trust deposits. A far more prudent course is to recognize, as this Court previously recognized in *Webb's,* that "[t]he earnings of a fund are incidents of ownership of the fund itself and are property just as the fund itself is property." 449 U.S. at 164.

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[19] In fact, even before the Texas IOLTA program was implemented, critics (including at least one member of the State Bar of Texas's "Client Protection Committee" that investigated the feasibility of an IOLTA program) strongly suggested that technological advances were undermining "the theoretical underpinnings of the plan -- the inability or impracticality of allocating small amounts of interest to the individual client." *See* T. Baker and R. Wood, *"Taking" A Constitutional Look at the State Bar of Texas Proposal to Collect Interest on Attorney Client Trust Accounts,* 14 Tex. Tech L. Rev. 327, 334 & n.38 (1983).

CONCLUSION

Respondents respectfully request that the judgment of the U.S. Court of Appeals for the Fifth Circuit be affirmed.

Respectfully submitted,

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